

TEACHERS' RETIREMENT BOARD  
BUDGETS AND AUDITS COMMITTEE

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SUBJECT: Overview of Internal Audit Program

ITEM NUMBER:   8  

ATTACHMENT(S):   4  

ACTION:       

DATE OF MEETING: July 12, 2001

INFORMATION:   X  

PRESENTER(S): Way Lee

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We are presenting this overview to provide new Board members with an orientation of the Office of Audits (OOA) internal audit activities and to inform all Board members of recent changes implemented within the professional practice of internal auditing. The profession has adopted a new definition and is in the process of establishing a new Professional Practices Framework that integrates key concepts, guidance, and standards from various internal auditing professional organizations into a single guide that delineates basic principles to practice under.

We have also taken this opportunity to discuss the internal control process, to identify various services the OOA performs, to provide some insight regarding the process we use to conduct audits, and to provide some background information on the OOA staff.

### INTERNAL AUDITING – REDEFINED

Our profession is governed by the Institute of Internal Auditing (IIA). The IIA redefined the term Internal Auditing in June 1999 to reflect the evolution of the professional practice and to guide internal auditors toward a larger, more influential role in the future. The IIA's new definition of Internal Auditing reflects the profession's movement toward risk-based auditing and consultative activities. The new definition also focuses *what* services internal auditors can provide rather than focusing on *how* we perform our work. We provided a comparison of the old and new definitions below and included a glossary covering some of new definition terms at Attachment 1.

<b><u>New Definition</u></b> of Internal Auditing	<b><u>Old definition</u></b> of Internal Auditing
Internal auditing is an independent, objective <u>assurance</u> and <u>consulting</u> activity designed to <u>add value</u> and improve an organization's operations. It <u>helps an organization</u> accomplish its objectives by	<i>Internal auditing is an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization. The objective of internal auditing is to assist members of the organization in the effective discharge of their responsibilities. To this end,</i>

bringing a systematic disciplined approach to evaluate and improve the effectiveness of <u>risk management</u> , <u>control</u> , and <u>governance processes</u> .	<i>internal auditing furnishes them with analyses, appraisals, recommendations, counsel and information concerning the activities reviewed. The audit objective includes promoting effective control at reasonable cost.</i>
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In December 2000, the IIA completed the first phase of revising the professional Standards into the Professional Practice Framework. The new Standards better reflect the current practice and new definition of internal auditing. The following table provides a historical overview of the Internal Auditing profession's change in focus over the past fifty years.

#### **HISTORICAL VIEW OF INTERNAL AUDITING FOCUS**

<b>Period</b>	<b>Control Focus</b>	<b>Organizations &amp; Management Science</b>	<b>Technology</b>	<b>Internal Auditing Standards</b>
1950's	Assets	Hierarchy	Manual	Safeguard Assets
1960's	Data	By Number	Mechanical	Reliability of Data
1970's	Compliance	Objectives	Automated	Compliance with Laws
1980's	Efficiency	Re-Engineering	Data Base	Efficiency & Effectiveness
1990's	Objectives	Virtual	Distributed	Achievement of Objectives
2000's	Risks	Risk Management & Corporate Governance	Internet	Value Added Services & Risk Based Approach

#### **INTERNAL CONTROL**

The American Institute of Certified Public Accountants (AICPA) defines Internal Control as the process effected by an entity's board of directors, management and other personnel designed to provide reasonable assurance regarding the achievement of objectives in the following:

- *Operations controls* –relating to the effective and efficient use of the entity's resources;
- *Financial reporting controls* – relating to the preparation of reliable published financial statements; and
- *Compliance controls* – relating to the entity's compliance with applicable laws and regulations.

The IIA Standards expand these risk management objectives further and address the need to also evaluate risk exposure and controls related to;

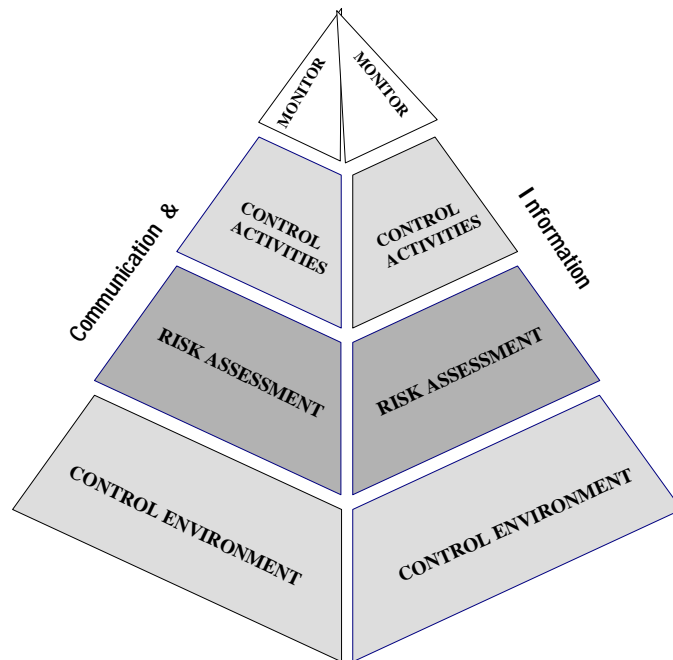
- *Safeguarding of assets; and the*
- *Reliability and integrity of operational information (as well as financial information).*

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) developed a framework for managing internal controls. COSO is comprised of representatives

from the AICPA, IIA, and other accounting associations or institutes. The AICPA professional standards adopted the COSO framework and identify internal control components as follows:

- *Control environment* – This is the foundation for the rest of the internal control components and represents management’s attitudes and support for internal controls.
- *Risk assessment* - Management must continually assess business risk and develop clearly defined control objectives.
- *Information and communication* - An effective system of internal control provides pertinent and timely information and communication. Relevant and timely information helps management assess and monitor the control environment and control objectives.
- *Control activities* - These are the policies and procedures that help ensure that management’s objectives are followed.
- *Monitoring* - Internal controls must be monitored on a routine and continual basis to ensure that they are effective and followed.

As indicated by the following illustration, all five components of an effective internal control system are inter-related:



The COSO also identified elements that lead to internal control failures. These include: Lack of Integrity, Weak Control Environment, Inconsistent Objectives, Poor Communication, and Inability to Understand and React to Changing Conditions. Management is responsible for implementing and maintaining an effective internal control system over the organization’s operational activities. Therefore, management is responsible to make decisions on the appropriate action that should be taken regarding significant observations and recommendations that are identified during internal audit activities. Senior management may decide to assume the risk of not correcting reported conditions due to cost or other considerations. The Chief Auditor is responsible for reporting to senior management and the

Board regarding any significant risk exposures, control issues, corporate governance issues, and other significant matters that are identified during internal audit activities.

## **SERVICES PROVIDED BY THE OOA**

Below we have provided a listing of the various services that the OOA provides. We followed the new IIA Professional Practice Framework and categorized the services as either assurance or consulting activities.

<b>Assurance Activities</b>	<b>Consulting Activities</b>
<ul style="list-style-type: none"><li>• Internal audits of Investments Branch activities/programs</li><li>• Internal audits of other CalSTRS' Branches</li><li>• School district compliance audits</li><li>• Individual member compliance case reviews</li><li>• Risk Assessments of the Investments Br. and all other operational branches</li><li>• State Administrative Manual section 20000 reviews</li><li>• Post-implementation evaluation reviews</li><li>• Special requests from the Board or senior management</li></ul>	<ul style="list-style-type: none"><li>• Coordination of external CPA's annual financial statements audit</li><li>• Best practices research</li><li>• Control self-assessments at county offices of education</li><li>• Participation on CalSTRS implementation teams and focus groups</li><li>• Technical assistance such as Governmental Accounting Standards Board applications, research, etc.</li><li>• Special projects requested by the Board or management such as the Comm. College FTE Review, the various START projects, etc.</li></ul>

Most of our staff resources are used to conduct internal audit and school district audit assurance services. To provide you with some insight as to how we perform these assurance services, we summarized the internal audit process and school district audit processes at Attachments 2 and 3, respectively.

### **Internal Audit Assurance Services**

Internal audit activity is necessary to evaluate and improve the effectiveness of an organization's risk management and ultimately help the organization achieve its established goals and objectives. Specifically, the Office of Audits (OOA) assurance services (audits) help management monitor and evaluate the reliability and integrity of financial and operating information. Audits also help management ensure that there's an effective control system in place to manage operational risks. The OOA's internal audit staff provide CalSTRS' management with an independent team of auditor/consultants that are educated, trained analysts and evaluators who have many years of experience identifying and evaluating risks and developing recommendations for improvements.

Most of our audits are operational reviews of the programs and activities (auditable activities) within CalSTRS' various branches. To manage the audit process, we perform two high (macro) level risk assessments of CalSTRS' auditable activities. One risk assessment covers Investments Branch activities and the other risk assessment covers the auditable activities within CalSTRS' other organizational branches. The last Investments Branch Risk Assessment we performed was reported to the Board in October 2000. Our presentation included a description of the macro level process. We plan to complete the CalSTRS Operations Risk Assessment during the current fiscal year and intend to perform both risk assessments on a biennial basis thereafter. Based on the results of our macro level risk assessments, we select auditable activities to include within our annual audit plan and perform a more detailed (micro) level risk assessment of the those activities during our assurance audit process.

Most of our audits represent the first internal review of an auditable activity. Therefore, our audit work focuses on preliminary survey procedures rather than sample tests of controls. The preliminary survey is necessary to identify and understand the sub-processes involved in the activity or program, the risks associated with the activity, and the internal control system that's currently in place to mitigate those risks. Where we identify sub-processes within an activity that require a more detailed, separate review, we add the sub-process to our listing of auditable activities and update/refine our macro risk assessment accordingly. For repeat audits of an activity or audits of a sub-process, we limit the scope of the audit work to testing the controls for moderate or high risk areas that were identified during the initial audit. Once we complete an audit, we update our macro risk assessment to reflect any changes needed.

To monitor the overall effectiveness of our internal audit assurance services, we use an internally developed evaluation survey to obtain input from management. Also, we measure our value added by the number of our recommendations that are implemented by management. In addition, the State's Department of Finance Quality Assurance reviews provide an external level of monitoring of our efficiency, effectiveness, and compliance with regulatory auditing standards.

As indicated above, further details regarding the various steps involved in conducting an internal audit are addressed at Attachment 2.

### **School District Audit Assurance Services**

During the past quarter, the School District audit team revised the methodology it used to select an audit sample. Our past sample selection for full-time active and retired members was mainly based selecting highly-paid administrators and teachers from the CalSTRS database. We changed to a more compensation-driven sample. The auditors review the bargaining agreements and pay and stipend code listings for any indication of potential erroneous reporting of member compensation. We then test employees who received this compensation. If the District inappropriately reported the compensation, we try to quantify the total dollar amount misreported. As a result, the upcoming audits should result in larger dollar findings and greater numbers of members whose earnings were erroneously reported.

As indicated above, the various steps involved in conducting a school district audit are addressed at Attachment 3.

## **OFFICE OF AUDITS STAFF**

Our Organizational Chart is provided at Attachment 4. The audit staff is currently comprised of nine auditors. Eight of them hold a CPA certification and three of the eight also hold other certifications such as Certified Internal Auditor (CIA), Certified Information Technology Professional (CITP), and Certified Government Financial Manager (CGFM). Our current audit staff has past auditing experience ranging from 7 to 23 years with an average of over 16 years of auditing experience per auditor.

The OOA's management team is comprised of Way Lee, Chief Auditor; Chris Berthold, Internal Audits Supervisor; and Randy Cortland, School District Audits Supervisor. We have provided some background information on our management team below:

- **Mr. Lee** is a licensed CPA and CIA, has four years of State accounting experience, five years of federal and State compliance auditing, and 16 years of internal auditing experience. He has been with CalSTRS for the last four years.
- **Ms. Berthold** is a licensed CPA, has 14 years of banking experience, five years of external auditing experience with the California State Auditor's office, and three years of internal auditing experience here at CalSTRS.
- **Mr. Cortland** is also a licensed CPA, and has 23 years of auditing experience with various State agencies. He has been with CalSTRS for the last two years.

### **GLOSSARY OF NEW INTERNAL AUDITING TERMINOLOGY**

<u>Assurance</u>	This concept includes traditional audit areas such as financial audits, compliance audits, operational audits, and economy and efficiency audits as well as newer forms of assurance from control and risk management audits. It is an objective examination of evidence for the purpose of providing an independent assessment on risk management, internal control, or governance processes for the organization.
<u>Consulting</u>	Consulting differs from assurance both in the nature of the service and context. Consulting seeks to make direct improvements in the circumstances or condition of an organization or customer. The nature and scope of work are agreed upon with the customer. Examples include facilitation, process design, training, and advisory services.
<u>Adding Value</u>	Internal auditors see adding value as a part of their role in any organization. Organizations exist to create value or benefit to their owners, stakeholders, customers, and clients. This concept provides purpose for their existence. Value is provided through their development of products and services and their use of resources to promote those products and services. By providing an assessment of the reliability or relevance of data and operations in specific organizational settings, internal auditors can add value in their services. This valuable information can be in the form of consultation, advice, written communications, or through other products all of which should be properly communicated to the appropriate management or operating personnel.
<u>Helps the Organization</u>	Internal auditing focuses on overall organizational objectives and the way those objectives are achieved at operational levels.
<u>Risk management, Control, and Governance processes</u>	<u>Risk management</u> identifies, evaluates and responds to potential risks that may impact the achievement of the organization's objectives. <u>Control</u> processes are the policies, procedures, and activities that are part of a control framework designed to ensure that risks are contained within the tolerances established by the risk management process. <u>Governance processes</u> provide oversight of risk and control processes administered by management. Corporate governance is taking on added importance as the need for accountability is felt in countries all around the world.

**OFFICE OF AUDITS**  
**Internal Audit Assurance Services**

**PROCESS TO CONDUCT CALSTRS' INTERNAL AUDITS**

<b>Audit Phase</b>	<b>Steps Involved</b>	<b>End Product</b>
<b><u>Administration</u></b>	<ul style="list-style-type: none"> <li>• Inform auditee of our plan to begin audit (as identified within OOA Annual Work Plan).</li> <li>• Determine areas of risk or issues previously identified in macro level risk assessment, prior internal audits, external audits, or other reports.</li> <li>• Conduct formal entrance conference with auditee.</li> </ul>	<ul style="list-style-type: none"> <li>• Job Start Letter to management</li> <li>• Document analysis in workpapers</li> <li>• Conduct/document entrance conference</li> </ul>
<b><u>Preliminary Survey</u></b>	<ul style="list-style-type: none"> <li>• Review CalSTRS' organizational Business Plan and Branch Management Plan to identify the goals and objectives related to activity being audited.</li> <li>• Identify the Program Policies, and Program Procedures for activity being audited.</li> <li>• Identify other criteria, rules, or regulations applicable to activity being audited.</li> <li>• Review Board Agenda items over past 24 months items that are relevant to activity being audited.</li> <li>• Research and ascertain audit issues and best practices relative to activity being audited using internet, survey of other public pension funds, training guides, auditing reference manuals, professional associations, periodicals, etc.</li> <li>• Develop list of questions for auditee &amp; list of key documents that auditor will need to review.</li> <li>• Conduct interview with key staff to resolve questions, identify auditee's view of program risks, controls, and any other issues.</li> <li>• Review key documents and interview staff to obtain an understanding of processes and/or subprocesses involved in the activity being audited.</li> <li>• Develop flowcharts, with supporting narrative, for key processes and control points. Evaluate strengths/weaknesses with existing control system.</li> <li>• Develop preliminary risk assessment. Identify key objectives, risk exposure, controls that mitigate risk, and initial observations of control strengths/weaknesses for activity being audited.</li> <li>• Discuss preliminary results with audit Supervisor and internal audit team to gain input and obtain direction for planning further audit procedures.</li> </ul>	<ul style="list-style-type: none"> <li>• Document analysis and conclusions in workpapers</li> <li>• (same)</li> <li>• (same)</li> <li>• (same)</li> <li>• (same)</li> <li>• Questionnaire to other public pension funds</li> <li>• Quest/doc listings to auditee</li> <li>• Conduct/document interview</li> <li>• Document analysis in workpapers</li> <li>• Flowcharts and narrative describing processes</li> <li>• Preliminary Risk Matrix document</li> <li>• Preliminary work is reviewed/signed off by Supervisor</li> </ul>



<b><u>Planning</u></b>	<ul style="list-style-type: none"> <li>Identify audit scope, objectives, and internal or external resources needed to conduct fieldwork.</li> <li>Develop specific audit procedures needed to obtain assurance that control structure is adequate in those areas ranked mod-high risk. Include procedures follow-up on any prior audit findings.</li> </ul>	<ul style="list-style-type: none"> <li>Audit Plan document</li> <li>Letter of Understanding to Management</li> <li>Audit Program document</li> </ul>
<b><u>Performing Tests of Controls</u></b>	<ul style="list-style-type: none"> <li>Conduct tests of controls, as identified above. Develop recommendations for improvement in policies, procedures, or processes based on results of testing.</li> <li>Keep auditee informed of any control weaknesses, errors, or irregularities identified during fieldwork.</li> <li>Re-evaluate prior assessment of risk.</li> </ul>	<ul style="list-style-type: none"> <li>Document fieldwork methodologies, analysis, and conclusions in workpapers</li> <li>Bi-monthly notification to auditee of audit status</li> <li>Update Risk Matrix</li> </ul>
<b><u>Communicating Results</u></b>	<ul style="list-style-type: none"> <li>Initiate pre-exit conference with key staff to discuss all observations of control weaknesses, errors, or irregularities and preliminary recommendations.</li> <li>Develop draft audit report and issue to auditee.</li> <li>Conduct formal exit conference with management and key staff.</li> <li>Obtain management's response to reported issues.</li> <li>Develop final report, incorporating management's response, submit to management.</li> <li>Report summary of audit results to Audits Committee.</li> </ul>	<ul style="list-style-type: none"> <li>Conduct/document pre-exit interview</li> <li>Issue Draft Report</li> <li>Conduct/document Exit Conference</li> <li>Document response</li> <li>Issue final Report to management</li> <li>Board agenda item to B &amp; A Comm.</li> </ul>
<b><u>Quality Assurance</u></b>	<ul style="list-style-type: none"> <li>Submit/track results of evaluation survey to auditee to identify internal audit process strengths and areas needing improvement.</li> </ul>	<ul style="list-style-type: none"> <li>Evaluation Survey sent to management</li> <li>Audit process and procedures modified</li> </ul>
<b><u>Follow-Up</u></b>	<ul style="list-style-type: none"> <li>Update Internal Audit Follow-Up database with audit observations, recommendations, and management's response.</li> <li>Contact management on quarterly basis to identify status of corrective action taken.</li> <li>Perform follow-up audit work as deemed necessary.</li> </ul>	<ul style="list-style-type: none"> <li>Internal Audits Follow-up Status Report to Board</li> <li>Update report quarterly</li> <li>(same as above)</li> </ul>

## SCHOOL DISTRICT AUDIT ACTIVITIES

<b>Audit Area</b>	<b>Activity</b>
<b><u>Audit universe</u></b>	Approximately 1,100 school districts, county offices of education, and community college districts are subject to CalSTRS audits. The Office of Audits cannot possibly audit all of these agencies with the limited staff that we have. However, we maximize our audit coverage by using the following techniques.
<b><u>Risk based approach</u></b>	<ul style="list-style-type: none"> <li>• Facilitating Reporting Risk Assessments at county offices of education to determine which districts in the county may have a high risk for reporting errors.</li> <li>• Analyzing referrals from CalSTRS Membership Division and the public for potential high-risk districts.</li> <li>• Covering California's various geographic areas.</li> <li>• Querying the CalSTRS database for high-risk districts or individual compliance cases. We query for large increases in compensation during the final compensation period.</li> </ul>
<b><u>Audit planning</u></b>	Once a district is selected for audit, we start the planning process. This process involves obtaining background information from within CalSTRS (such as a query of the database system for compensation reported by a school district for all of its CalSTRS members during our audit period and asking Membership for any pertinent information about the district). Planning also includes obtaining from the district and reviewing in advance of the field work start date bargaining agreements, organization charts, pay code listings, and other documents that detail the district's pay structure.
<b><u>Field work</u></b>	<p>The next major process is to compare the district's payroll and human resources records to member information reported (or not reported) to CalSTRS. We test the following areas in conjunction with a standard set of procedures (e.g., audit program) and the CalSTRS laws and regulations.</p> <ol style="list-style-type: none"> <li>1. Proper notification of membership rights and procedures to certificated employees and enrollment into CalSTRS membership when a certificated employee becomes automatically eligible.</li> <li>2. Correct reporting of members' pay rates and compensation.</li> <li>3. Inclusive reporting of retirants' earnings.</li> <li>4. Correct reporting of retiree information used to calculate extra service credit for unused sick leave.</li> <li>5. Correct calculation of retirees' allowances.</li> </ol>
<b><u>Audit report</u></b>	We conclude the audit by issuing a draft report on the results of our conclusions. We schedule the internal Audit Report Review Committee meeting to discuss the draft report before we issue the copy of the draft report to district officials and any retired member whose retirement allowance may be affected. We consider the responses to our draft report before issuing the final report to the district and county office of education with a summary to the CalSTRS Board's Budgets and Audits Committee.

## CalSTRS ADMINISTRATION BRANCH

### OFFICE OF AUDITS Organization Chart as of June 2001

